Capital Gearing Trust

Q2 2023 Report

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A brave new world

The new normal will not look like the recent past

The history of the international monetary system is characterised by regimes. Over the past century, there have been several: various iterations of the Gold Standard, Bretton Woods, the Volcker inflation period, and most recently the Great Moderation. When commentators refer to the "return to normal", it is important to remember that what constitutes normal is always state dependent, and the recent past is unlikely to be a good guide to the future normal.

It has for some time been our contention that after decades of low inflation and stimulative monetary policy, we are now entering a new regime. This is a consequence of changing structural factors – including increased protectionism, climate-related expenditure and demographic change – and the more recent supply-side shocks to economies, principally the disruption caused by the Covid pandemic, and Russia's subsequent unprovoked invasion of Ukraine. These developments have combined to create a more inflationary economic environment. Perhaps most significantly, they have contracted the elasticity of aggregate supply, meaning that demand-led monetary policy is less directly able to counteract the underlying dynamics as it has in the past.

The regime that we are entering will be characterised by elevated but more volatile inflation, a return to more pronounced business cycles, and tighter for longer monetary policy. A recent speech by Gita Gopinath, the Deputy Managing Director of the IMF highlighted a series of "uncomfortable truths" about monetary policy, highlighting that the tighter policy regime will heighten financial system fragility, and inflation may have to remain elevated for some time in response to any breakage. The new era has pronounced consequences for the investment environment – most starkly characterised by the recent volatility in financial market prices – but also has important consequences for the optimal balance sheet of companies going forward.

In light of this new era, there is now also a series of uncomfortable truths that management, boards and investors will need to face:

1. *Higher interest rates will impact companies' balance sheets from both directions.* Higher interest rates reduce asset valuations, and in doing so, mechanically increase gearing ratios. This is in addition to the erosion of equity caused by increased debt servicing costs.

2. *Restrictive monetary policy will not just increase the cost of debt finance, but will also reduce its availability*. An important feature of quantitative tightening is that it reduces the size of the banking sector's balance sheet, and in doing so reduces the supply of credit. It does this in addition to increasing effective interest rates. This means that the range of scenarios used to stress test companies' balance sheets will need to be much wider than it has been in the past. It also means that companies with upcoming refinancing obligations should increase their emphasis on securing the appropriate financing as soon as possible and at a fixed rate.

3. *The appropriate balance sheet for the future will be much less levered than it has been in the past.* In the previous regime of ever-falling interest rates and ever-increasing asset valuations, it was possible to increase returns through gearing. This approach to financing has been predominant across a range of asset classes, including infrastructure and property. Given falling asset valuations and rising costs of debt, it is likely that a number of sectors that choose to finance marginal expansion with debt will face a negative financing, where the cost of debt exceeds the expected return on the asset.

We have already seen downward pressure on asset valuations as interest rates continue to rise in the face of increasingly persistent inflation. However, the path of adjustment to the new regime will see further downward pressure. In most cases, achieving a lower level of balance sheet gearing will require that companies will need to sell assets to pay down debt. In the situation where deleveraging needs to take place economy-wide, there are likely to be more sellers than buyers.

On an historical note, it is important to remember that negative financing has not been uncommon. In the 1970s, modest negative financing did take place, and could still deliver a positive return where the cost of debt was fixed and the extent of inflation was such that there was confidence that the nominal value of the assets would rise. However, given the current fragility of the economy and the financial structure, we would not expect negative financing to be common. Our expectation is that the companies which act early to reduce gearing and fix their cost of debt for the long term will be positioned best to weather a brave new world.

Peter Spiller
Emma Moriarty
June 2023

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Fund information as at:

30th June 2023

Share price:

£45.40

Investment objective

The Company's objective is to preserve, and over time to grow shareholder's real wealth.

Fund information

Market Cap.	£1.2bn
Dividend Yield	< 1%
OCF*	0.52%
OCF (PRIIPS)	0.78%
Comparator Index	RPI

*Ongoing Charge Figure

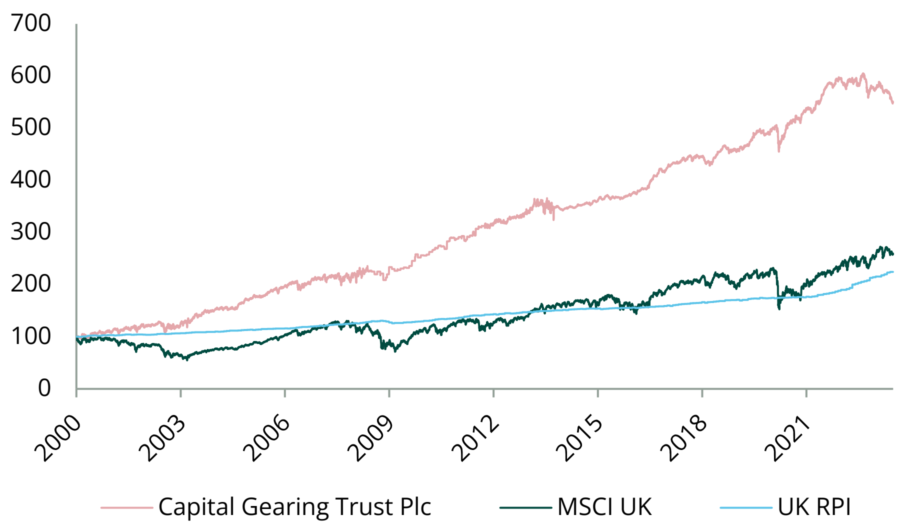
Return history (total returns)

1 month	-1.1%	2022	-3.1%
3 months	-2.3%	2021	11.3%
6 months	-3.0%	2020	8.3%
Year to date	-3.0%	2019	8.6%
1 year	-2.9%	2018	2.1%

Largest fund/equity holdings

Ishares MSCI JP ESG Screened ETF	4.0%
SPDR MSCI Europe Energy ETF	2.7%
Lyxor Stoxx 600 Basic Resources	1.5%
North Atlantic Smaller Co's	1.4%
Greencoat UK Wind	1.2%

Performance since January 2000 (total return)



Largest bond holdings

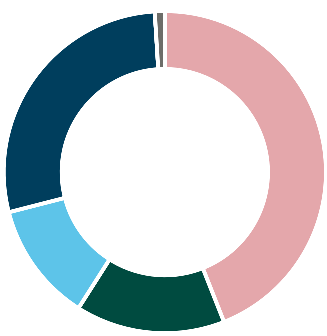
UK I/L 0.125% 22/03/24	10.8%
UK I/L 0.125% 22/03/29	5.5%
US I/L 0.625% 15/02/43	2.9%
US I/L 0.75% 15/02/45	2.0%
UK I/L 0.125% 22/03/26	1.9%

Currency exposure

GBP	59%
USD	20%
SEK	4%
EUR	4%
JPY	9%
Other	4%

Asset allocation

Index Linked Gov't Bonds	43%
Conventional Gov't Bonds	15%
Pref Shares / Corp Debt	12%
Funds / Equities	27%
Cash	2%
Gold	1%



Fund/equity breakdown

Property	4%
Equities	11%
Infrastructure	6%
Loans & Junk Bonds	3%
Energy Equity	4%

Party like it's 1999

When the financial history of the post-COVID era is written, the most striking detail will be the sheer breadth of elevated asset prices. It was truly an "Everything Bubble". Of course, there were the poster-children bubbles: SPACs, non-profitable tech, crypto, NFTs and so on. Perhaps the greatest, less publicised bubble was found within the bond market, which is the largest asset class of all. The obverse of the prevalence of bubbles was that there was, essentially, nowhere to hide.

This is in stark contrast to the environment surrounding the Dotcom bubble. Then there were plenty of cheap assets, most notably value equities and government bonds. The challenge a fund manager faced then was not in finding attractively priced assets but rather having the nerve to hold such an unfashionable portfolio with all the attendant career risk.

Are markets beginning to look more like 2000 and less like 2021? First the similarities, tech is making a resurgence. The FANG+ Index is up 75% YTD and has driven most of the gains for the S&P500. The outperformance of growth vs. value, while not comparable with the Dotcom era, is back at 2021 highs[1]. It is priced at 40x this year's earnings. Given those kinds of multiples you would be forgiven, dear reader, for expecting exceptional growth from these companies. In fact, both sales and earnings of the index are scheduled to fall this year versus last. Our "What were you thinking?" Index, which counts the number of companies in the S&P500 (ex-real estate) trading at more than 10x revenues, has fallen back from the stratospheric levels of the "Everything Bubble" and is back to mere "Dotcom Bubble" levels[2]. Given that margins for US equities are much higher today, it doesn't immediately follow that equities are as expensive today as they were then. Nevertheless, the similarities are considerable.

The similarities do not extend to government bonds. While they offer dramatically better value than they have been in recent years, they aren't remotely as attractive as in 2000. At the turn of the century the US 10 year yielded 6.6% against 3.9% today. Estimates of term premia explain nearly all of the difference. What of real rates? 10 year real yields in the US started the century at 4%, today they stand at 1.6%. In the intervening years, trend growth has fallen and debt risen which means that the natural rate of interest has fallen. So while real rates are less attractive in absolute terms, relatively speaking they aren't bad.

Where should the value oriented investor turn? The investment trust market is starting to throw up opportunities. Discounts in conventional equity trusts are widening and the fund is increasing its buying activity. High quality infrastructure assets are particularly out of favour. Greencoat UK Wind, HICL and their brethren are offering, we judge, prospective nominal returns of c. 10% per annum. These are high quality stocks offering high returns and have much lower risk than the equity market overall. Nevertheless, they are *still* equities and they also carry a number of idiosyncratic risks that differ from the broader equity market: regulatory risk, power price risk and they have higher interest rate sensitivity.

Perhaps the closest parallel to 2000 is corporate credit and short government rates. The yield on the sterling corporate bond index is 6.7% today vs. 6.9% at the turn of the century. Over the subsequent 3 years the index returned about 10.5% per annum compound. Today, the fund's corporate bond yield is rather higher, but given the duration is very much shorter, it is improbable that such returns could be repeated. Nevertheless, we believe credit – alongside our treasury bills – offers good shelter against expensive markets.

Chris Clothier
June 2023

[1]The FANG + Index comprises: Tesla, Meta Platforms (Facebook), Apple, Amazon, Microsoft, Netflix, NVIDIA, Snowflake, Alphabet, AMD
[2]Hat-tip to Jesse Felder who is the inspiration for the index. "What were you thinking?" of course refers to Scott McNealy's famous quote

Heads in the sand

In Oscar Wilde's Lady Windermere's Fan, Darlington is reminded that a sentimentalist "is a man who sees an absurd value in everything and doesn't know the market price of any single thing". Private market practitioners might be forgiven then for clinging blindly to valuations, reassured by their lived experience of consistent multiple expansion and their mastery of financial engineering to achieve it, but the disconnect to public market prices is stubborn. It has been suggested that over the last decade the majority of returns attributed to private equity have been sourced from lower interest rates. Accustomed to this low cost of debt, much of the industry abandoned established hedging practices. As recently as January, over 70% of the debt raised in Europe since 2021 remained exposed to rising interest rates, or about three-quarters in the US. This year, as rates rise further, these structures will find little sympathy from Fed Chairman Jerome Powell's peerage as a buyout baron[1]. Over 12m people are employed by the industry in the US. With interest costs at the median North American private equity-backed business at 43% of EBITDA last year, there are few places to hide from a prolonged period of hawkish policy[2].

Infrequent valuations and the lower volatility these bring have made alternatives a popular holding but large discrepancies can arise between the reported and "de-smoothed" returns. One example is the GREFI index, which gave a positive total return of 3.8% for private real estate in 2022, whilst the publicly listed NAREIT index lost 24%. A lagged effect has begun to emerge in the former, the private index is off 2.8% in the first quarter of this year[3]. UK listed alternatives and investment trusts with large private holdings have not been immune with discounts wider than seen during the financial crisis. Listed private equity share prices imply valuation discounts between 30-40%. As investors reflect on this against a precarious economic outlook, and compelling values in fixed income. Allocations to the sector are becoming more selective, not all voluntarily. Some alternative managers are discovering the price of liquidity as they are forced to contend with redemptions.

8% of the portfolio is in alternatives, 5% of this is listed infrastructure which looks attractive. Technical factors contributed to a capitulation in listed infrastructure towards the end of the quarter, where average discounts to NAV exceed 20%. Unlike private equity, gearing levels are lower, largely fixed for the term of debt and amortising. There is strong inflation linkage in both core infrastructure, and in renewables where roughly half of the revenues are government-backed inflation-linked and the balance exposed to power prices at varying degrees depending on hedging arrangements. The implied returns also preserve a reasonable equity risk premium. We have also taken a more active approach, engaging with management and boards to commit to asset sales, reduce gearing and initiate repurchases that maximise shareholder value. The failure of boards to contain these discounts challenges the lower volatility associated with these assets and could undermine future issuance. We invite fellow investors to challenge boards on their commitment to responsible governance of shareholder capital.

The portfolio is defensively positioned with risk assets at 27%. Index linked bonds were reduced by 2% over the quarter to 43%, this was attributed to a 4% reallocation out of TIPS with duration maintained at around 10 years with a barbell structure. 2% was invested into UKTIs (23% of the portfolio) and the remaining distributed across UKTBs (11% of the portfolio) and short dated investment grade corporate credit (12% of the portfolio) where rising yields offered attractive entries.

Whilst the historical record implies attractive prospective returns in alternatives at current prices, the lookback period is constrained to a favourable interest rate regime, and technical conditions could get worse before improving. Portfolio dry powder is primed to capitalise on attractive entry points as they arise. In the interim a 5.8% risk free return on treasury bills and a 7.3% average yield on the portfolio's short dated corporate credit is an exciting threshold to exceed.

Hassan Raza
June 2023

[1]Bloomberg and Man Group Plc

[2]Verdad Advisers

[3]JPM Alternative Investments Outlook and Strategy 2023

The least worst option

The dollar spot index has fallen almost 15% from its September 2022 peak, stimulating a flurry of discussion about de-dollarisation. The main case against the dollar system is founded on rising political risks as the US increasingly weaponises its monetary hegemony. Most striking was the freezing of the foreign reserve assets of the Russian state after the 2022 invasion of Ukraine. This confiscation compounded the sense of extra-territorial coercion raised by the secondary sanctions regime through which the US can cut off any commercial bank anywhere from the dollar system if they finance sanctioned entities. Meanwhile the same US congress was flirting with debt default during May by threatening not to extend the debt ceiling. None of these political risks are ideal in a reserve currency and have resulted in the large-scale buying of gold by nervous foreign exchange reserve managers keen to avoid the long arm of US foreign policy. Both Russia and Brazil now denominate certain commodity trade with China in renminbi.

Based on geopolitical and economic influence China would seem the obvious alternate monetary pole but in practice the renminbi remains a minnow on the global stage. A majority of China's cross-border trade is still conducted in dollars. The debts linked to China's own "belt and road" infrastructure projects, an obvious opportunity to internationalise the remnimbi, are denominated in dollars. China's senior leadership shows no desire to open up its capital account or to develop a huge offshore market in safe assets to rival US Treasury bonds. China has developed a parallel domestic monetary infrastructure to defend itself against US coercion but this is very different from developing the global infrastructure to promote the remnimbi as a rival reserve currency. Currently less than 5% of global currency reserves are held in remnimbi compared to greater than 60% held in dollars.

In 2018 significant Russian energy exports to Europe and China switched denomination from the dollar into the euro, as Russia responded to the Magnitsky sanctions regime passed by US Congress under Donald Trump. Europe was keen to distance itself from Trump's trade wars and positioned itself as an apolitical supporter of the global rules-based system. This shift resulted in Russia building up its euro reserves, a move that (with hindsight) provided no protection against asset freezes in 2022 as the EU, UK and US moved in lockstep. Any reserve managers concerned about the US's muscular dollar policy may now conclude there is little to be gained from diversifying into euro reserves, particularly given the euro bond market is dramatically less liquid than the Treasury market and is lower yielding. Unsurprisingly a major European land war has left the euro's role in the global financial architecture diminished.

Larry Summers summed up the position with his usual hyperbole, "Let's be honest here: Europe's a museum, Japan's a nursing home and China is a jail". The US Federal Reserve is the only central bank willing and able to backstop a global monetary system and the Treasury market is the only asset class with the depth and liquidity to lubricate such an undertaking. The political risk associated with the muscular dollar, whilst inconvenient, is dwarfed by its practical benefits for trade. Russia's recently expanded oil trade with India remains largely denominated in dollars. Russia would love it to be otherwise but there is no viable alternative.

Treasury Inflation Protected Securities ("TIPS") offer investors a credit and inflation risk free way of holding the global reserve currency. In our opinion there is no comparably attractive asset class for those focused on wealth preservation. The fund's portfolio currently yields 2.3% real and has approximately 10-year duration. Simplistically stated, investors in this portfolio can rely on growing their spending power by c.2% ahead of inflation denominated in the global reserve currency for many years into the future. The case for TIPS as a cornerstone asset of portfolios remains emphatically intact.

Alastair Laing
June 2023

Disquiet on the Western Front

Central banks are now, collectively, at least eighteen months into a war against a more persistent form of inflation than has been seen for several decades. The exact battle faced by each central bank differs. In the UK, the Bank of England is yet to see a genuine downturn in headline rates of inflation. Abroad, the Federal Reserve has paused its path of rate rises to take stock of their collective impact as headline inflation falls steadily. Further afield, the Reserve Bank of Australia is reconsidering the pace of its rate rises to avoid falling into the recession that its neighbour, New Zealand, has already entered. As ever, we will be watching these developments closely.

But as central bankers focus on the immediate issue at hand, a more fundamental economic shift is beginning to take hold: globalisation is in retreat. It is important not to understate the impact of this. At the end of the 1980s, the fall of communism signalled the arrival of a new geopolitical era characterised by the US-led hegemonic and economic stability. This era brought with it increased economic integration of former eastern bloc countries. The most significant new entrant to the economic system was China. The sheer increase to the quantity of labour and capital that this represented fundamentally altered the scale and elasticity of aggregate supply available to the global economy. Critically, it has placed persistent downward pressure on global goods prices ever since.

The tides are now shifting. Recent developments suggest that the stability of the US-led global order is being eroded. This has become evident following the sanctions placed on Russia after the invasion of Ukraine, and the subsequent energy crisis that has ensued across Europe. It is also more subtly in play in the growing rivalry between the US and China. The US policy response, embedded in the Inflation Reduction Act, has been to emphasise spending to build 'supply security'. The European strategic autonomy agenda has a similar aim. These government policy initiatives have since cascaded into individual firms' planning: since Russia invaded Ukraine, the share of global firms planning to regionalise their supply chain has almost doubled. In aggregate, this redraws traditional trade routes and creates a more multipolar global economy. Within each pole, aggregate supply becomes more constrained and less elastic. The consequences of this are inevitably inflationary.

This change has not gone unnoticed. Christine Lagarde, President of the European Central Bank, recently spoke on the role of central banks in a two-bloc global economic system.[1] In Lagarde's exposition, the two largest world economies compete to pull the rest of the world closer to their economic and strategic interests. The conclusion was clear: in a regime where aggregate supply is the dominant constraint, gone are the Keynesian days where central banks act as "conductors of the international orchestra". The implications of this are twofold. First, governments must take a more active role in managing inflation by avoiding broad-based deficit spending and instead targeting supply constraints more directly. Secondly, central bank responses, which target aggregate demand, will have to be outsized to counteract supply-driven inflation.

The reversal of the *Pax Americana* will have implications for index-linked bondholders. The fund's index-linked bond portfolio, which currently yields 2%, represents a portfolio of inflation-linked credit to the highest quality sovereigns aligned to the Western bloc. In an environment of more persistent inflation and a tighter monetary policy stance, investors will benefit from a higher running yield on the bond portfolio, and increased inflation accruals over the life of the underlying bonds. The extent of this will, of course, depend on the nature of nations' responses to fragmentation. Larger blocs with greater policy cohesion will produce lower volatility and inflation than the alternative. In the meantime, we should begin to consider the new reality that may lie ahead.

Emma Moriarty
June 2023

[1] Speech by Christine Lagarde, 'Central banks in a fragmenting world', 17 April 2023. Available at: https://www.ecb.europa.eu/

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